

## TEACHERS' RETIREMENT BOARD

### INVESTMENT COMMITTEE

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SUBJECT: Internal Equities –  
Internal Indexed Portfolio Policy Revised

ITEM NUMBER: 12

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: July 10, 2002

INFORMATION: \_\_\_\_\_

PRESENTER(S): Steven Tong

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#### **Executive Summary**

In 1997, the Investment Committee reaffirmed a portfolio structure that placed 20% of the domestic equity assets in “active” mandate and the remaining 80% in “passive.” The Investment Committee expects the active mandates in aggregate to outperform the domestic equity asset class benchmark over time. The Committee also expects the passive mandate in aggregate to closely match the performance of the benchmark.

In May 2002, the Investment Committee adopted the Russell 3000 Index (ex-Tobacco) as the benchmark for the CalSTRS’ domestic equity portfolio. This benchmark will be used to create performance standards against which CalSTRS’ passive portfolio, active managers, as well as the total domestic equity portfolio can be evaluated. The change from the old to new benchmark will become effective on July 1, 2002.

The CalSTRS’ passive domestic equity portfolio can be decomposed into large-cap and small-cap segments; furthermore, it is broken into two sub-benchmarks:

Russell 3000 ex-Tobacco Index = Russell 1000 ex-Tobacco Index + Russell 2000 ex-Tobacco Index  
100% = 93% + 7%

This structure is an alternative to the existing structure (S&P 500 Index/Russell Small Cap Completeness Index; both ex-Tobacco) and better matches the performance of the Russell 3000 ex-Tobacco Index. The CalSTRS’ internal passive management program is a segment of the overall passive component of the domestic equity portfolio; comprising one-half of the large-cap portion (as represented by the Russell 1000 ex-Tobacco Index).

In order to reduce the potential performance variance between the total passive domestic equity portfolio and its benchmark, CalSTRS will need to implement the alternate structure. As a result, a modification to the current Internal Indexed Portfolio (Portfolio) policies is needed. Attachment 1 provides the proposed changes to the Portfolio policies. The policies for the

Portfolio have been revised to reflect a change in the benchmark from the S&P 500 ex-Tobacco Index to the Russell 1000 ex-Tobacco Index.

### **Recommendation**

Staff recommends that the Investment Committee adopt the revised policies, as shown in Attachment 1, for an internal indexed domestic equity portfolio with a performance benchmark of the Russell 1000 ex-Tobacco Index. Pension Consulting Alliance has reviewed the proposed changes to the policies and concurs with Staff's recommendation for approval.

Date prepared: June 14, 2002

By:

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Steven Tong  
Director of Internal Equities

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Deborah Contini  
Investment Officer III

Review & Concur:

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Christopher J. Ailman  
Chief Investment Officer

## California State Teachers' Retirement System Internal Indexed Portfolio Policies

This document outlines the policies for the management of CalSTRS' internal indexed domestic equity portfolio. These policies are designed to set the boundaries for oversight and management of the portfolio, while allowing sufficient flexibility in the management process to manage risk and capture investment opportunities. The policies approved by the Board cannot be changed without the approval of the Board.

### Internal ~~S&P 500~~ Indexed Portfolio Policies

Policies for the management of the internal ~~S&P 500~~ Indexed portfolio (Portfolio) are listed below:

1. The domestic equity assets of CalSTRS are to be invested in a prudent manner for the sole benefit of its participants and beneficiaries, in accordance with applicable portions of the California State Teachers' Retirement Law.
2. Based on the Investment Management Plan, the Portfolio's performance objective is to seek to realize a performance of the Russell 1000 S&P 500 ex-Tobacco Index ("R1000 S&P 500 XT Index" or "Benchmark"), as reported by the master custodian. The deviations between the performance of the Portfolio and the benchmark (tracking error) should be contained and move randomly within the set range. The annualized tracking error will be limited to +/- 0.~~0812~~% (~~812~~ basis points). A larger tracking error will be allowed as the result of a deliberate decision to reduce turnover or to control a specified risk contained in the Portfolio. The Portfolio will not hold any securities prohibited by the most recent Investment Resolution.
3. To achieve the stated performance objective, the Portfolio invests in a diversified portfolio of equity securities in the Benchmark. The Portfolio will be managed in a passive manner, with risk characteristics closely resembling the R1000 S&P 500 XT Index. Security transactions will be performed when necessary to approximate the characteristics of the R1000 S&P 500 XT Index and fulfill the performance objective. When the R1000 S&P 500 XT Index is expensive to fully replicate due to temporary circumstances such as transaction costs or market liquidity, an optimized approach with fewer stocks may be used with the approval of the Chief Investment Officer.
4. The value of the internal indexed portfolio will be 50% (minimum allocation of 45% and maximum allocation of 55%) of CalSTRS's total R1000 S&P 500 XT Index passive mandate.

5. The total holdings of securities in the Portfolio issued by any one U.S. corporation shall be limited to five (5%) percent of the total issued and outstanding shares of that corporation.
6. ~~S&P 500 Index~~ Futures contracts and Exchange-Traded Funds (ETFs) may be used for equitizing cash positions.
7. All transactions will be carefully evaluated to determine the expected benefits to the Portfolio. Efficient trading strategies will be utilized in order to minimize market impact and transaction costs. In all transactions, investment personnel shall use best efforts to obtain the most favorable execution available at the time of the trade.
8. Brokers will be selected for their quality of execution, quality and timeliness of the operation area, and creditworthiness. A diversified group of brokers will be used to insure overall quality of trade executions.
9. ~~The Chief Investment Officer has the authority to manage the Portfolio internally and may use other investment personnel for the management of the Portfolio.~~
10. ~~CalSTRS' investment personnel have authority to manage the Portfolio internally. The Chief Investment Officer has the authority to trade appropriate securities for the Portfolio and may designate other investment personnel to act for him/her with regards to investments for the Portfolio.~~ The daily limits for approval of trades are designated below:

Chief Investment Officer	\$1 billion
Director of Internal Equity	\$500 million
Principal Investment Officer	\$300 million
Investment Officer III	\$200 million
Investment Officer II	\$100 million
Investment Officer I	\$50 million
11. Authorization letters which indicate who may transact business for the Portfolio, including a copy of the most recent Investment Resolution, shall initially be sent to the broker at the time the account is established. Whenever there is a change in authorized personnel, CalSTRS will ~~immediately~~ notify all brokers in writing by the end of the next business day within twenty-four (24) hours.
12. The Chief Investment Officer shall monitor the investment policies and report to the CalSTRS' Board quarterly or as otherwise requested.

Adopted by the Teachers' Retirement Board on January 7, 1998  
Revised on October 11, 2000  
Revised on July 11, 2001  
Revised on July 10, 2002

PROPOSED  
RESOLUTION OF THE  
TEACHERS' RETIREMENT BOARD  
INVESTMENT COMMITTEE

SUBJECT: Internal Equities – Internal Indexed Portfolio Policy Revised

Resolution No. \_\_\_\_\_

WHEREAS, the Investment Committee of the California State Teachers' Retirement Board is responsible for recommendations to the Board, investment policy and overall investment strategy for the management of the Teachers' Retirement Fund, a multi-billion dollar public pension plan; and

WHEREAS, the Investment Committee is charged with developing the Fund's Investment Policies and Management Plan including the policies for individual classes such as domestic equity; and

WHEREAS, the Investment Committee has received and reviewed written recommendation for the policy change and has heard oral presentations from Staff, and

WHEREAS, it is the Committee's desire to revise the existing policy for the internal indexed portfolio. Therefore, be it

RESOLVED, that the Investment Committee of the California State Teachers' Retirement Board approves the revised Internal Indexed Portfolio Policy.

Adopted by:  
Investment Committee  
on July 10, 2002

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Jack Ehnes  
Chief Executive Officer